

Bill Lockyer on Moody's Move Towards Unified Ratings Scale

The Treasurer of California, Bill Lockyer speaks with us today about Moody's proposal to move to a single unified rating scale and their extended comment period. He identifies supporters and opponents of ratings reform and addresses the self-interests of banks in supporting his agenda.

DerivActiv MuniMarket Pulse podcast

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Interviewee: Bill Lockyer, Treasurer of the State of California

Interviewer: Johan Rosenberg, CEO of DerivActiv, LLC, and
President of Sound Capital Management, Inc.

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Episode Transcript:

Johan – You have taken part in numerous discussions with issuers, investors and intermediaries, were these just you or were they you and other issuers, municipalities or professionals? How did these interviews transpire?

Bill – We contacted them and they had various meetings, both in person, with groups as well as on numerous conference calls.

Johan – And they seem to be listening. They're are extending this comment period for public finance rating scale and they seem to be also veering towards a single rating versus having two ratings.

Bill – I think that's why they extended the comment period is that they changed their basic idea rather than two different scales, they are now contemplating one that's less confusing to investors. I think that's a good idea. The unknown issue at the moment is to what extent that single scale provides information, of what quality and source. As a municipal issuer, the largest in the country, we are concerned that investors get the most valuable information which is what's the risk of losing their money. I think that's the key thing. The best information that investors need and that the rating scale ought to

basically reflect that potential for default. The old current system has a lot of other objective factors and Moody's continues to talk about some continuation of those subjective evaluations in the scale and so we don't know yet what that means exactly or how significant it may be and things of that sort.

Johan – What about the two other rating agencies? Do you have any conversations with them or are they kind of just sitting on the sidelines watching what's going to happen next?

Bill – No, there have been active discussions with them as well. We are not exactly sure what their timeline might be. Perhaps for Fitch for example, later in the summer. But we're a little less clear about their timetable. With respect to S&P, S&P basically is I think dishonestly claimed that they had one single scale all along and in order to try to make that claim credible, what they've been doing is upgrading a lot of municipal issues and so that's their way of trying to integrate the analysis and methodology. It's a lot less forthcoming than the Moody's approach, but it could get to the same outcome. We just don't know yet.

Johan – I noticed here that there are quite a few investment banks and banks, very large ones, that submitted comments in favor of the ratings reform. On the one hand I thought they are being advocates for their clients, one of their most important client base, but on the other hand I was chewing on this a little bit and I realize that there is a whole lot of agreements out there which have triggers which occur on downgrades and then bonds become bank bonds. Investors then have the right to put these bonds to the banks. So in a way it serves the clients, but it also serves them to have this happen because if everybody gets upgraded the likelihood that muni bonds become bank bonds on reimbursement agreements and things of that nature is much less. Do you think I'm on to something there?

Bill – I think it's very complicated to try to discern the self interest of any of the large investment houses. They have so many different constituencies and clients and sections of their business that one of the things we've found is that there was often vigorous debate inside about whether this was a good thing or not. The resistance to some improved ratings for municipal issues that would basically reflect the much less lower likelihood of default, which is basically our perspective and claim about what these ratings should go. The resistance has been from some very sophisticated investors that basically game our interest yields and get a little better deal because you might be an A rating or some other state might be A or AA that probably should be a AAA. So they get a few extra basis points on that trade. Now what I found is when people thought it through, while there was that sort of short-term resistance, increasingly what happened is this sort of logic: people would say, the big investors would say, 'we may be making some extra money because of this market inefficiency attributable to the rating agency miscalculations, there may be some inefficiency that helps in the short run, but we're in the market all the time buying and selling. And so when we sell, the inefficiency hurts us.' So isn't it just better to have a transparent, efficient market that investors can understand. They know how safe their money is when they buy these particular issues.

So I think that logic eventually became compelling and they discovered there was kind of self interest on both sides of the transaction. I think that more than anything is the way in which these matters got resolved.

Johan – When you are talking large investors, are you talking about multi-billion hedge funds or bank portfolios?

Bill – It varied with different groups. Many of the hedge funds though it would be a good idea to make these changes. Those segments of large funds that are restricted to AA credits or money market accounts, would love more liquidity in having a greater pool of AA which would likely happen if there is some upgrades here. But the resistance mainly came from Fidelity, Vanguard, AllianceBernstein, some of those who either just are comfortable with the way things are or find that the way things are, that they made more money.

Johan – There is talk of legislation being proposed by House Representative Barney Frank to require the rating agencies to adopt a corporate equivalent rating scale for municipals. What's your reaction to this proposal?

Bill – I'm delighted that Congressman Frank and others have gotten involved in this discussion. They understand how taxpayers have basically been treated unfairly and discriminated against in the marketplace because of the rating agency methodologies and they don't think it's fair and they're struggling with the right way to see that there are changes. I think people would prefer that they be done voluntarily, however we are not yet convinced that we are going to actually wind up with a non-discriminatory system yet, so we will have to wait and see how that goes. But it's encouraging that chair of the financial services committee is involved in this discussion.

Johan – The last couple weeks MBIA and Ambac got downgraded and lost their AAA ratings, or they're on negative watch with an indication for A. Has that affected California at all?

Bill – The only real effect has been the contraction in the monoline incurrence availability. That's not just true with that firm but is generally true in the market and so there's the question of what investors want. It's unclear what the value of insurance is today compared to perhaps years back and then if it's of value, where you can obtain it, what price.

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